Board Briefing ibe

# Responsible Financial Reporting
## doing the right thing

By Guy Jubb

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**.... makes for better business”**

Board Briefing

# Responsible Financial Reporting
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**By Guy Jubb**

**Responsible Financial Reporting:** doing the right thing

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# Contents

| | | Page |
|---|---|---|
| **Author and Acknowledgements** | | 4 |
| **Forewords** | | 5 |
| **Executive Summary** | | 7 |
| **Introduction** | It Takes Courage | 9 |
| **Chapter 1** | The Legal and Regulatory Context | 11 |
| **Chapter 2** | Putting Principles into Practice | 16 |
| **Chapter 3** | The Hallmarks of Responsible Financial Reporting | 19 |
| **Chapter 4** | The Threats to Responsible Financial Reporting | 22 |
| **Chapter 5** | The Critical Dilemmas | 29 |
| **Chapter 6** | The Implications for Independent Non-Executive Directors | 37 |
| **Conclusion** | | 44 |
| **Related IBE Publications** | | 46 |

## Author

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After qualifying as a chartered accountant in Edinburgh in 1976, Guy worked in London and New York before joining County Bank in London in 1981. He was recruited by Touche Ross in 1984 to join its corporate advisory team. In 1986, he returned to Edinburgh to join Standard Life, where he was responsible for setting up its smaller company and private equity investment teams. He pioneered the development of Standard Life's corporate governance team in 1992 which has made governance and stewardship an integral part of its investment service. He retired from Standard Life in 2016 as Global Head of Governance & Stewardship.

Guy served on many influential committees, including the Association of British Insurers Investment Committee and the Standing Advisory Group of the Public Company Accounting Oversight Board (PCAOB), the US audit regulator. He was Co-Chair of the Global Auditor Investor Dialogue, the Conference Board's European Corporate Governance Council, and the GC100 and Investor Working Group. In 2015 Guy was the recipient of ICSA's Outstanding Achievement Award.

Guy chairs the Constitutional Panel and the Strategy & Research Advisory Group of ICAS, the Institute of Chartered Accountants of Scotland, and is a member of its Council. He is a Director of the European Corporate Governance Institute (ECGI), and an adviser on governance, accountability and stewardship.

## Acknowledgements

I am very grateful to Peter Montagnon and Philippa Foster Back for the inspiration and invitation to address responsible financial reporting as part of the IBE's Board Briefing series. Also for their guidance and encouragement to help enrich the content of the Briefing and to lift my spirits when they flagged along the way.

The team at the IBE provided me with tremendous support throughout, for which I am greatly indebted. In particular, I thank Monia Wadham, who took care of all the editorial responsibilities with efficient calmness, which ensured I never lost any sleep worrying about such matters. Also, I thank Simon Webley, whose comments on an early draft were invaluable.

Alison Thomas, Liz Murrall, John Plender and Norman Murray, my external reviewers, all deserve a special mention for not only so willingly taking the time and trouble to plough through the paper but also providing challenging and constructive comments, which served to identify a number of important omissions and errors as well as contribute to the shape and flow of the Briefing.

Last but by no means least, my thanks go to Iain Anderson of Cicero Communications, who kindly agreed to host the launch.

# IBE Foreword

Responsible Financial Reporting is the latest in our series of Board Briefings aimed at helping directors – and those that advise them – address what can often be difficult questions. Financial reporting is no exception because, in so many places, accountancy rules allow for choice and judgement, and where that is the case there is always an ethical dimension.

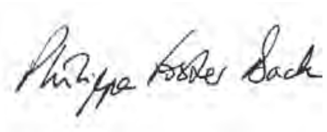
In this Briefing Guy Jubb lays out the issues in a way which, we hope, will be useful not just to directors who sit on audit committees but to all those that serve on boards. One of the important things to remember is that all directors, not just the Audit Committee, are responsible for the accounts and all directors, therefore, need to be aware of possible conflicts and how to deal with them.

The IBE has commissioned this report for two reasons. The first for the ethical dimension set out above, and to remind ourselves that ethics is not just a question of getting corporate responsibility, compliance and operational behaviour right. We need to break down the silos and realise that there is an ethical dimension to everything that goes on inside a company, including what some may wrongly be inclined to dismiss as number-crunching. Ethics and compliance practitioners need to be aware of this and make sure their approach is a holistic one.

As Guy rightly points out, the core values of the firm should be applied in every area where decisions are made and judgement exercised. Truthfulness, integrity, fair presentation and consistency are among the hallmarks he identifies of responsible accounting and these are likely to reflect the basic values of companies which take ethics seriously.

As we have noted before, doing the right thing makes for better business and, in a hard-nosed way, it is also a good way of mitigating risk. Risk arises not just from malpractice in the supply chain or failure to address health and safety. The risks arising from poor financial reporting can be devastating – as the financial crisis showed. Questions about the role of accounting arise elsewhere, including recently in accounting for government contracts.

Our thanks to Guy for his thoughtful work, which will promote better practice, and to HSBC for supporting its publication.



**Philippa Foster Back** CBE
Director
Institute of Business Ethics

# Foreword from HSBC

Operating with high standards of conduct is central to the long-term success of all businesses. Doing so enables companies to create lasting relationships with customers, shareholders, employees and the wider communities they serve.

If we are to inspire the confidence and earn the trust of all of these groups, we need to think carefully about how to deal with complex trade-offs and be fully accountable for our decisions. Financial reporting is an important element of how we create a culture of accountability.

As a global financial institution which seeks to connect customers to opportunities, HSBC places great value on gathering the right information to help us make better decisions about who we do business with, and where we lend and invest. Equally, we understand the importance of presenting the same high quality information about our own business to investors and shareholders, so they can understand our financial position.

One of the primary tasks of the board of directors is to ensure the quality and accuracy of the financial results being presented to the shareholders they represent. So it is important that we ensure they not only possess an understanding of the regulatory sanctions and corporate governance codes covering reporting, but they are empowered to demonstrate independence of thought, character, judgment and a sense of duty that goes beyond the individual's self-interest or the narrow interest of the firm.

HSBC is therefore pleased to support this IBE Board Briefing, which marks an important further step towards improved financial reporting that can help businesses to win the confidence and trust of their stakeholders.

HSBC

HSBC is one of the world's largest banking and financial services organisations. With around 4,000 offices in both established and emerging markets, we aim to be where the growth is, connecting customers to opportunities, enabling businesses to thrive and economies to prosper, and helping people to fulfil their hopes and realise their ambitions.

# Executive Summary

The board of directors has the ultimate responsibility to prepare and approve financial statements that show a true and fair view. The audit committee plays an important role in assisting the board by providing advice. But the buck stops with the board. In a unitary board each and every director shares that burden of collective responsibility.

It can be challenging for independent non-executive directors, especially when they do not have financial expertise, to engage effectively in board discussions about the financial statements. To assist them, this Board Briefing examines a number of dilemmas that arise when preparing and approving financial statements. These include decisions around revenue recognition, mark-to-market valuations [1], changing accounting policies, and accounting policy choices.

The consolidated accounts of UK listed companies have to be prepared under International Financial Reporting Standards (IFRS) and show a true and fair view. IFRS are principles-based standards. They require boards and management to make assumptions and exercise judgement; directors have to navigate a minefield of issues and dilemmas, not least ethical ones. Sometimes, the resolution may be straightforward; at other times, it is wise for the directors to seek independent advice to help them reach the right decision, especially as the Financial Reporting Council (FRC) is seeking additional powers to tighten regulatory enforcement to apply to all directors, not just those who are professional accountants.

In exercising their responsibility to prepare financial statements that show a true and fair view directors need to demonstrate the following six hallmarks of responsible reporting:

- **Truthfulness and integrity**
- **Fair presentation**
- **Neutrality supported by prudence**
- **Consistency**
- **Completeness**
- **Comprehensibility**

*These hallmarks are not optional extras – they are essential ingredients*

These hallmarks are not optional extras – they are essential ingredients.

Threats to responsible financial reporting are omnipresent. Self-interest is a frequent cause of material misstatements. It can sometimes be difficult, especially for independent non-executive directors, to identify where self-interest may be festering but directors must be constantly vigilant and never ignore the risk and its consequences. The tone from the top must be fit for purpose and there must be an open culture that embraces integrity and the company's values, within and without the boardroom.

[1] Mark-to-market or fair value accounting refers to accounting for the 'fair value' of an asset or liability based on the current market price, or that for similar assets and liabilities, or based on another objectively assessed 'fair' value.

Independent non-executive directors must use all the resources at their disposal in seeking the truth that is the foundation of responsible financial reporting. They must challenge accounting policies and how they are applied, as well as the accuracy of the information used. They must probe related party transactions, which can often be controversial when viewed through the lens of shareholders. They must go out of their way to get feedback on the financial statements from professional analysts and shareholders. Last but not least, they should take steps to ensure that the auditors bring to bear an appropriate degree of professional scepticism.

# Introduction: It Takes Courage

Doing the right thing has become a *cri de coeur* of business leaders, regulators and politicians around the world. The focus – and rightly so – has been on business practices, especially in relation to consumers. Very little attention is given to what it means to do the right thing when it comes to corporate reporting. This is somewhat surprising given the importance that users of financial statements attach to the integrity of those statements, and the serious consequences to the financial standing of the company and its directors, non-executive as well as executive, if the wrong calls are made.

Audited financial statements that purport to show a true and fair view provide the life blood for capital markets as well as the basis on which shareholders hold the board of directors to account for their stewardship of the company's assets. Accordingly, it is essential that they are prepared and presented such that shareholders and others trust their integrity.

Principles-based financial reporting standards, such as IFRS, require boards of directors to make judgements and assumptions in order to present the financial performance and position of their companies in a true and fair way. In making assumptions and judgements, directors have to address a range of ethical and other dilemmas in seeking to do the right thing. They must be constantly alert to the numerous threats that could undermine the presentation of a true and fair view, such as the pressures to meet targets in order to trigger bonuses.

This Board Briefing examines the environment that pervades financial reporting, not least the omnipresent pressures to reach targets. It builds on the foundation of both the legal responsibilities of directors and the guidance provided by the FRC. Using examples, it provides an overview of the ethical conundrums that boards and their audit committees face, highlighting the critical contribution made by the values-based culture supporting the financial reporting process.

The conceptual hallmarks of responsible financial reporting that provide a framework for decision-making by boards and their audit committees are cornerstones. They include neutrality supported by prudence, truthfulness and integrity. These hallmarks are not negotiable when it comes to presenting a true and fair view. Directors must also be vigilant to the ethical threats to responsible financial reporting and the ways in which they can corrupt the true and fair presentation of the financial information that is at the heart of sound stewardship and accountability to stakeholders and shareholders. These threats include the self-interest of directors, inappropriate culture and tone from the top, and the asymmetry of information between executives and non-executives.

Judgements and assumptions abound when applying IFRS. When judgements have to be made, ethical considerations are never far away. As well as some of the more obvious dilemmas, such as revenue recognition and ensuring it is reported in the correct reporting period, this Board Briefing considers the ethical dimensions of recognition and disclosure when it might prejudice the short-term interests of the company. Also, mark-to-market valuations, tax transparency and share price implications come under scrutiny.

Independent non-executive directors play a critical role in the financial reporting process. They must challenge the accounting policies and how they are applied in order to ensure their consistency with the hallmarks of responsible financial reporting. The audit committee, in particular, must be visibly and influentially involved in the key parts of the financial reporting cycle. However, in a unitary board all directors must take responsibility for ensuring that the financial reports show a true and fair view. When things go wrong with financial reporting, the buck stops with the board, not just the audit committee.

The risks of failing to grasp the ethical dimension should never be underestimated. Shareholders and stakeholders, including regulators, employees and consumers, expect independent non-executive directors to take a firm stand when it comes to responsible financial reporting and do the right thing. Their own reputation and ethical standing are on the line, to say nothing of the potential financial consequences of failing to have the courage to do the right thing.

“*The reputation and ethical standing of independent non-executive directors are on the line*

# The Legal and Regulatory Context

## The legal responsibilities

The legal responsibilities relating to the preparation of the annual report and accounts are enshrined in the Companies Act 2006. Every company is required to keep 'adequate' accounting records [2] that must be sufficient to show and explain the company's transactions and to disclose with reasonable accuracy the financial position of the company. Although this requirement may seem to some independent non-executive directors to border on micro-management, it is vital that they do not gloss over it. To do so, as well as being a dereliction of duty, risks undermining the preparation of responsible financial statements before the process has even started. If the accounting records are not adequate, there is little hope of the financial statements ever showing a true and fair view.

The directors – executive and non-executive – have a collective responsibility for preparing the annual report and accounts. [3] They must not approve the financial statements unless they are satisfied that they give a 'true and fair view' of the assets, liabilities, financial position and profit and loss of their company and, in the case where the company has subsidiaries, of the group as a whole. [4] The true and fair requirement intentionally incorporates a degree of flexibility, which empowers directors to exercise judgements and make estimates. It is the true and fair view that lies at the heart of the ethical dilemmas that directors face when preparing responsible financial statements.

> *It is the true and fair view that lies at the heart of the ethical dilemmas*

It is important to emphasise that it is the responsibility of the directors and not the auditors to prepare financial statements that show a true and fair view. The auditors' role is to attest as to whether the financial statements that have been approved by the board show a true and fair view. Independent non-executive directors must resist the temptation to delegate their responsibilities for making difficult decisions and judgements to the auditors. If they feel they need independent financial advice to assist them in reaching a true and fair view, they should seek such advice from providers of professional services who are independent of the auditors. [5]

The Financial Reporting Council expects boards of directors 'to stand back and ensure that the accounts as a whole do give a true and fair view'. [6] When directors do not believe that following a particular accounting policy will give a true and fair view, they are legally required to adopt a more appropriate policy, even when this requires a departure from a particular accounting standard. This is commonly referred to as 'the true and fair override'. However, the International Accounting Standards Board (IASB) has stated in International Accounting Standard 1 that departures from the standards should only be necessary in 'extremely rare circumstances'.

[2] Companies Act 2006, Section 386

[3] Companies Act 2006, Section 394

[4] Companies Act 2006, Section 393

[5] Provision B.5.1 of *The UK Corporate Governance Code* (2016) provides that 'The board should ensure that directors, especially non-executive directors, have access to independent professional advice at the company's expense where they judge it necessary to discharge their responsibilities as directors.'

[6] Financial Reporting Council (2014) *True and Fair*

In effect, the IASB's statement creates such a high burden of proof on a board, it has served to be self-fulfilling. Such departures are indeed extremely rare and it requires considerable courage by a board to invoke a true and fair override. This presents a challenge to directors insofar a true and fair override potentially exposes their judgement to considerable critical scrutiny by shareholders, regulators and commentators. Arguably, it results in boards and auditors opting to 'play it safe' and deciding to comply with accounting standards that may not deliver a true and fair view but not expose them to unwelcome scrutiny. A notable exception was the board of HSBC Holdings, which invoked the true and fair override in its 2009 interim report when accounting for a £12.5 billion rights issue. It considered that compliance with the provisions of the relevant international accounting standard would not only be misleading but also would not have resulted in a fair representation of the transaction, and consequently might induce an adverse impact on the economic decisions made by the users of the financial statements. [7]

## The UK Corporate Governance Code ('the Code')

The Code, which is maintained by the FRC, operates on a 'comply or explain' basis and is the corporate governance benchmark for UK listed companies. One of its main principles is that 'The board should present a fair, balanced and understandable assessment of the company's position and prospects'. [8] In addition, one of the Code's provisions is that the directors should state that the annual report and accounts 'provides the information necessary for shareholders to assess the company's position and performance, business model and strategy'. [9] This is a critical benchmark for independent non-executive directors, especially when there is pressure to put a positive spin on financial and other information. When reporting they should call a spade a spade – nothing more and nothing less, erring on the side of prudence when appropriate.

The Code also addresses the role and composition of the audit committee. It provides that the audit committee should 'monitor the integrity of the financial statements' and review 'any significant financial judgements'. [10] Furthermore, the Code provides that 'when requested by the board, the audit committee should provide advice on whether the annual report and accounts, taken as a whole, is fair, balanced and understandable, and provides the information necessary for shareholders to assess the company's position and performance, business model and strategy. [11] It is important to note that the audit committee's role is to 'provide advice'; a responsible board should discuss and, when appropriate, challenge that advice. It is the board's responsibility, not that of the audit committee, to approve the financial statements. In doing so, the board must consider carefully the consistency in both message and tone – and of the assumptions used – between the financial statements and the other information in the annual report.

> *The buck stops with the board, not the audit committee*

[7] See HSBC Group *2009 Interim Report* at http://www.hsbc.co.uk/1/PA_esf-ca-app-content/content/uk/pdfs/en/hsbc_bank_plc_interim_report_2009.pdf

[8] Financial Reporting Council (2016) *The UK Corporate Governance Code*, Principle C.1

[9] Financial Reporting Council (2016) *The UK Corporate Governance Code*, Code Provision C.1.1

[10] Financial Reporting Council (2016) *The UK Corporate Governance Code*, Code Provision C.3.2

[11] Financial Reporting Council (2016) *The UK Corporate Governance Code*, Code Provision C.3.4

Any variances should be investigated and resolved before the financial statements are approved. All directors should recognise that investors are placing increased reliance on the information in the board's strategic review and corporate governance statement when making investment decisions. The buck stops with the board, not the audit committee.

### The UK Corporate Governance Code: The Main Role and Responsibilities of the Audit Committee

The main role and responsibilities of the audit committee should be set out in written terms of reference and should include:

- to monitor the integrity of the financial statements of the company and any formal announcements relating to the company's financial performance, reviewing significant financial reporting judgements contained in them
- to review the company's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, to review the company's internal control and risk management systems
- to monitor and review the effectiveness of the company's internal audit function
- to make recommendations to the board, for it to put to the shareholders for their approval at a general meeting, in relation to the appointment, re-appointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor
- to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements
- to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm; and to report to the board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken; and
- to report to the board on how it has discharged its responsibilities. [12]

[12] Financial Reporting Council (2016) *The UK Corporate Governance Code*, Code Provision C.3.2

## The Financial Reporting Council

The FRC is the UK's regulator for corporate governance, corporate reporting, investor stewardship and auditing. As such it is responsible for maintaining relevant codes and overseeing their application. It is also responsible for the accounting standards used by those UK companies that are not required to use IFRS. In recent years, the FRC has been placing particular emphasis on the importance of corporate culture to sustainable success and effective corporate governance.

To supplement the codes and to promote best practice, the FRC publishes guidance for directors to, *inter alia*, assist them in preparing responsible financial statements. The guidance is varied and is available on the FRC's website.[13] It includes thematic guidance, guidance on contemporary reporting issues and guidance to address specific issues raised by investors and others. It is important that all independent non-executive directors read the FRC's guidance, since it is of critical importance to fulfilling their responsibilities.

"The FRC is seeking to extend its enforcement powers to all company directors

Also, the FRC has responsibility for reviewing annual reports and financial statements with a view to ensuring compliance with relevant reporting standards and other provisions. The FRC will inform a company when it has undertaken a review and will provide feedback when appropriate. In situations where it has significant concerns, the FRC may take more robust action, consistent with the nature of the concerns. The FRC's enforcement powers are currently limited to auditors, individual professional accountants and actuaries but it is seeking to extend its enforcement powers to all company directors.

**Extract from the announcement by the Financial Reporting Council on the findings of the Financial Reporting Review Panel in respect of the accounts of Sports Direct International plc for the year ended 26 April 2015**[14]

The FRC has discussed certain issues with the company following its review of the 2015 annual report and accounts.

The principal issue arising related to whether the 2015 strategic report complied with the Companies Act 2006 requirement to be balanced and comprehensive.

In this regard the FRC noted that

- there was no discussion of the development and performance of the company's international stores in its Sports Retail division, which represent a significant part of the company's operations in terms of the number of stores, total revenue, operating result and gross profit

*continues*

[13] https://www.frc.org.uk

[14] For the full announcement see https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2016/December/Findings-of-the-Financial-Reporting-Review-Panel-i.aspx

- one of the company’s key performance indicators, Sports Retail like-for-like stores gross contribution, excludes stores that have not been owned by the company for the full 12 months in both periods. Therefore, in 2015 this key performance indicator excluded the contribution from the stores in Austria and the Baltic states acquired in 2014; and

- there was no discussion of the performance of these stores or their effect on the company’s results.

On the basis of information provided by the company, the FRC also considered whether the aggregation of the UK and international Sports Retail stores was in accordance with IFRS 8 ‘Operating Segments’.

Following discussion with the FRC, the directors have decided to include specific commentary about Sports Retail’s international stores in its narrative reporting, including the strategic report, and to present separately segmental information about these stores in the accounts.

Following the corrective action taken by the company, the FRC regards the enquiries as concluded.

2

# Putting Principles into Practice

IFRS are used by UK listed companies when preparing consolidated financial statements which are intended to show a true and fair view. IFRS are principles-based, not rules-based standards. Accordingly, in applying the principles, directors must make carefully considered judgements. As a consequence, shareholders and other users should benefit from financial statements that have been prepared thoughtfully and after due consideration by the directors. Principles-based standards are generally regarded by users as far more relevant and useful for decision-making purposes than rules-based standards. However, in making judgements, the directors have to face, consciously or unconsciously, a wide range of ethical issues. They have to navigate a minefield of conflicts – confidentiality, market expectations and executive remuneration to name but three. Sometimes, resolution of these conflicts will be straightforward and clear-cut. At other times, the resolution will be complex, difficult and challenging; indeed, it may require input from external independent advisers to assist the directors in making their decision. Auditors are not necessarily best placed to provide such input – they must maintain their independence at all times and should not be providing input to judgements which they then have to audit.

As a practical matter, getting external independent advice is sometimes easier said than done. The behavioural dynamics of boards, particularly relating to mutual trust, often mitigate against seeking a second opinion. However, one of the main principles of The UK Corporate Governance Code is that *'the board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties'*. [15] Furthermore, this principle is supported by a provision that *'The board should ensure that directors, especially non-executive directors, have access to independent professional advice at the company's expense where they judge it necessary to discharge their responsibilities as directors'*. [16] To help ease potential tensions, and as a matter of good practice, boards should have in place arrangements for directors to obtain such advice as matter of course, rather than as a matter of exception.

> *The culture of the financial reporting process itself is critical*

The culture of the financial reporting process itself is critical to ensuring the preparation of reliable financial statements. Although the CFO normally has responsibility for the day-to-day running of the financial reporting process, the board as a whole, and the audit committee in particular, have a responsibility for ensuring not only that effective internal controls are in place, but also that the culture that is brought to bear by those involved in the process is consistent with the company's standards – at all times. If a corrupt culture infects the financial reporting process, it is like a cancer that progressively undermines the true and fair view of the financial statements, unless it is treated – and treated swiftly and effectively.

[15] Financial Reporting Council (2016) *The UK Corporate Governance Code*, Main Principle B.5

[16] Financial Reporting Council (2016) *The UK Corporate Governance Code*, Code Provision B.5.1

The independent non-executive directors cannot and should not turn a blind eye to the cultural issues. Instead, they should continually, throughout the course of the year, monitor the culture and interact – and be seen to interact – with the members of the finance team in a way that will contribute to their understanding of the prevailing cultural environment. They can also enlist internal audit to assist, but in doing so, they must always be mindful that internal audit, even though this is no longer regarded as best practice, will often report, directly or indirectly, to the CEO or CFO and may therefore be prone to bias. Increasingly, internal audit's ultimate reporting line is to the audit committee; this is a welcome trend which serves to mitigate the risks of bias.

Likewise, the board must champion the company's values and be seen to do so. Culture and values go hand-in-hand; you can't have one without the other. The board needs to actively monitor how the company's values are implemented throughout the company, including how they are applied by those involved in the financial reporting process.

In addition, it is recommended that the audit committee discuss the quality of internal controls and cultural environment with the external auditors at regular intervals during the course of the year. Furthermore, the chairman of the board should ensure that when the annual financial statements are signed off by the board, the external auditors attend the board meeting and discuss with the board as a whole their views on the financial reporting process, including its cultural aspects. It is important that the discussion should be a meaningful one that should engage the board as a whole – not just the audit committee members. In the event that the external auditor has concerns, these need to be carefully evaluated by the board in general, and by the independent non-executive directors in particular. Such concerns should not be brushed under the boardroom carpet. Rather, they should be addressed and resolved in a thoughtful and appropriate manner.

> *The external auditor's concerns should not be brushed under the boardroom carpet*

The importance of reliable financial statements that show a true and fair view of a company's financial performance and financial position are a foundation of capital markets and this should never be underestimated. They are essential for the efficient allocation of capital and corporate accountability, not only to shareholders but also to creditors. Corporate history is littered with scandals arising from unreliable financial statements that have subsequently torpedoed the companies – often in spectacular style. And they have often had far-reaching consequences that have damaged confidence in capitalism, corporate governance and the markets. The role of dishonour is long and includes Polly Peck, Enron, the Mirror Group and Lehman Brothers.

More recently, scandals at Tesco, BT and Toshiba highlight the corrosive damage that can be done as a consequence of financial reporting that failed to meet the expectations of the market. In all cases, the buck stopped with the board and it is its failure to exercise proper responsibility that is called into question.

*Toshiba shareholders accuse group of 'chronic culture of lying'*

FT, 30 March 2017

*Tesco faces £100m damages claim over accounting black hole*

Daily Telegraph, 26 January 2016

*BT loses almost £8bn in value as Italy accounting scandal deepens*

Guardian, 24 January 2017

In July 2017, Carillion, the international support services business, issued a profit warning and a strategic review [17] which prompted the Chief Executive to step down with immediate effect, triggering a 39% fall in its share price on the day of the announcement. The company's announcement referred to 'an expected contract provision' of £845 million. An analyst was quoted in the Financial Times as saying, 'it looks like the board had been a tad over-optimistic for too long'. The 'catalogue of areas of concern' was 'mainly around over-optimistic assessments of expected profitability and worse than expected contract cash flows', he said. 'Arguably, this write-off should have happened several years ago and has been bad news waiting to happen.' [18]

Small wonder that the FRC has signalled its wish to have a much stronger role in disciplining all directors – not just those who are accountants or actuaries – who fail to act responsibly in the future. [19]

[17] Carillion RNS 10 July 2017 http://otp.investis.com/clients/uk/carillion1/rns/regulatory-story.aspx?cid=376&newsid=890068

[18] https://www.ft.com/content/4ca80d5a-6537-11e7-8526-7b38dcaef614

[19] FRC Press Notice 'FRC Responds to Green Paper on Corporate Governance Reforms', 21 February 2017 states: 'The FRC also proposes extending its powers to investigate and prosecute all directors for financial reporting breaches and associated issues of integrity, rather than only accountants and actuaries.'

3

# The Hallmarks of Responsible Financial Reporting

A responsible process for preparing financial accounts requires directors to display the hallmarks below. These hallmarks are not optional. Directors cannot pick and choose between them. They must be applied throughout the process. The hallmarks are not rocket science but it is surprising how often they are overlooked or circumvented. When the tide goes out, the shortcomings are exposed – and so are the directors.

## Truthfulness and integrity

Responsible financial statements show a truthful account of the company's performance and financial position. They need to have integrity from start to finish. This hallmark represents an unashamedly very high standard that is expected of directors. The independent non-executive directors have a responsibility to challenge management in order to satisfy themselves, individually as well as collectively, as to the truthfulness of the information to be reported; they have an implied responsibility always to seek the truth. This means that they have to keep asking questions – gnawing on the bone – until they are satisfied that the information is complete and trustworthy. It is not acceptable for independent non-executive directors to put truthfulness into the 'too difficult tray'. They must dig, dig and dig some more, until they are satisfied that they have established the truth.

> *Independent non-executive directors must dig, dig and dig some more*

## Fair and objective presentation

The numbers to be reported may themselves be truthful and have integrity but when it comes to reporting them, it is very important that they are fairly presented and free from the bias of management and the board. Management has a natural bias to be optimistic – and often over-optimistic. As well as human nature, this bias can be fuelled by a wide range of factors. These include satisfying market expectations and meeting targets in order to trigger executive bonuses and long-term incentive payments. As a consequence, there can be a natural tendency to call a half empty bottle a half full bottle. But bias is not just a curse of management; boards of directors themselves are vulnerable to the bias of groupthink. It is important that independent non-executive directors are always alert to this possibility and are prepared to speak up when their conscience is troubling them, especially when they think they are in a minority – often a minority of one. It is the responsibility of the chairman of a board to encourage individual directors to speak openly and to have a boardroom culture that respects the power of one. Courage should be encouraged.

> *Courage should be encouraged*

## Neutrality supported by prudence

Over the years, there has been much debate within the accountancy profession, and by accounting standards setters and investors, about the relative importance of prudence and neutrality – and the subtle differences between them – in the preparation of financial statements that show a true and fair view in accordance with IFRS. In its Exposure Draft of its *Conceptual Framework for Financial Reporting* [20] the IASB explains the role of prudence, which it describes as 'caution when making judgements under conditions of uncertainty. With reference to neutrality, the IASB states that 'A neutral depiction is not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users'. It recognises that neutrality is 'supported by the exercise of prudence'. Investors who, over the years, have suffered significant financial losses when prudence and neutrality have not been properly applied by boards, have expressed, with due conviction, concerns about the risk of overstating assets and income and understating liabilities and costs. For example, in its comment letter to the IASB on its Discussion Paper on the *Conceptual Framework*, the Investment Management Association stated that 'Investors want companies to err on the side of caution'. [21] [22]

> *Neutrality is supported by the exercise of prudence*

Irrespective of the finer points of the distinction between neutrality and prudence, investors look to boards and their audit committees to be vigilant with regard to valuation and measurement. Independent non-executive directors provide a very important check and balance in this regard, and should have a natural disposition towards challenging and counteracting management's optimism when fulfilling their responsibilities in approving the financial statements. That said, they must ensure that neutrality is not compromised and that prudence is not used as an excuse to over-provide materially for liabilities and costs, which results in provisions that are not required, which in turn conflicts with truthfulness and integrity. Such over-provision is referred to by some commentators as 'cookie jar accounting' and can be used inappropriately to smooth earnings and mask periods of underperformance when excessively prudent provisions for liabilities, which were unnecessary in the first place, are released to flatter performance.

> *It is not acceptable to chop and change*

## Consistency

Preparing responsible financial statements requires consistency in the way that accounting standards are applied over time. The same applies to the way in which information is presented. It is not acceptable to chop and change from one year to another or bring different interpretations to bear when applying IFRS, unless there has been a substantive change in circumstances that makes such a change consistent with a true and fair view.

[20] IASB *Conceptual Framework for Financial Reporting*, published 28 May 2015. The IASB aims to finalise the revised *Conceptual Framework* in 2017.

[21] Investment Management Association letter 'A Review Of The Conceptual Framework For Financial Reporting - Discussion Paper', 15 January 2014 https://www.theinvestmentassociation.org/assets/files/consultations/2014/20140114-iasbdponfinancialreporting.pdf

[22] The Investment Management Association (IMA) is now known as The Investment Association (IA).

Independent non-executive directors have to be alert to the possibility that management may seek to flatter reported performance or the balance sheet position by proposing a change to the accounting approach previously used. Sometimes even a small tweak can have a disproportionate impact. In the event that a change is proposed and it is agreed by all the directors, then it is generally sensible to inform the market and shareholders in advance, so that it can be anticipated in an orderly way. Also, this helps to demonstrate that the changes were carefully considered rather than opportunistic.

## Completeness

Responsible financial reports tell not only the truth but also, in all material respects, the whole truth. From an ethical perspective, there are two tests that need to be met: First, it is not acceptable – and it is unlawful – for boards to leave out information that is material to the presentation of a true and fair view. Second, it is not acceptable for directors to omit information that would be useful to decisions by shareholders and other users. Boards often face significant challenges when having to address how to deal with the disclosure of commercially sensitive information. It is often useful, especially for the independent non-executive directors, to have standing principles-based guidelines to assist the board in its decision-making in such situations. For example, guidelines to assist directors when making decisions in respect of disclosure of post balance date events which are known to the board and may be commercially sensitive but could have a significant impact on the decisions made by investors. Such guidelines would provide a useful reference framework to help the board in the preparation of responsible financial statements.

> *Responsible financial reports tell not only the truth but also, in all material respects, the whole truth*

## Comprehensibility

> *Financial statements will not be responsible unless they can be understood*

One of the criticisms that is often levelled at financial statements, especially those of companies engaged in financial services and other complex activities, is that nobody really understands them. Responsible financial statements must be capable of being understood by not just professional analysts but also by retail investors, whose knowledge of the jargon and technical aspects of the business activities should be assumed to be significantly less than professional users. Although financial statements may show a true and fair view and be compliant with all the other underlying concepts, they will not be responsible unless they can be understood by individual shareholders as well as their arguably more sophisticated professional counterparts.

4

# The Threats to Responsible Financial Reporting

It is impossible and unrealistic to identify all the threats – ethical and otherwise – to responsible financial reporting. This Briefing describes some of the generic threats to assist independent non-executive directors in exercising good, sound judgement during their involvement with the preparation and approval of the financial statements. It is important that the independent non-executive directors from time to time stand back from the day-to-day discussions in the boardroom and consider carefully – and objectively – whether these threats are relevant to the company and, if so, challenge and exercise discretion in good measure in order to ensure these do not undermine high standards of ethical behaviour and the quality of financial reporting.

When post-mortems are conducted to determine the cause of material misstatements and fraud, a root cause is often the self-interest of an executive, or a group of executives, who are below the radar organisationally from the board's perspective but nevertheless play a critical role in channelling critical information into the financial reporting process. The nature of the self-interest can vary enormously. On the one hand, it could be a desire to cover-up false accounting, especially when it has been undertaken for many years and remains undetected. On the other hand, the motive may be more behavioural and less clinical, such as the desire of a retiring and long-serving executive to leave with a legacy of perceived success, when the reality is a rather different picture that only comes to light after he or she has left, or simply the fear of not reporting good results.

*Self-interest can vary enormously*

It is challenging for a board, especially of a very large organisation, to detect where these pockets of self-interest are festering. However, that does not mean that they should ignore the risk. Quite the reverse. The board needs to be satisfied that the internal auditors are visiting all the centres that contribute materially to the financial reporting process. Internal audit's site reviews should address the totality of the control environment, which includes not only the usual financial and operational checks but also an assessment of the cultural environment. A good internal auditor should be well attuned to the signs of cultural problems but, given their nature, it can often be difficult to refer to them explicitly in written reports. Therefore, the audit committee should have regular face-to-face sessions with the senior members of the internal audit department to discuss their findings on the cultural environment and consider what action to take if it is felt that the issues arising could impact on the financial statements. In addition, it is sensible for the audit committee to meet at least annually with the Head of Internal Audit 'in executive session', without any other executives, to discuss where self-interest risks are arising and, perhaps as importantly, where there is scope for them to arise in the future, and how they can and should be mitigated.

*'Internal audit is a unique function within an organisation with its independence and access to give assurance to those in the boardroom. This can provide confidence that there is a strong commitment to good conduct and that it is actually being translated into everyday behaviours, but also, more importantly, where it is not. To have this information allows the board an opportunity to mitigate the risk of integrity failure.'* [23]

Philippa Foster Back CBE, Director, Institute of Business Ethics

The same approach applies to the external auditors. It is acknowledged that the nature of external auditing is evolving rapidly. In particular, and especially in the audit of large companies, more and more of the audit checks are undertaken remotely, focussing on data analytics and using robotics and other forms of artificial intelligence. Whilst this removes much of the human interaction that used to take place during the course of an audit – making it potentially more difficult for the external auditors to assess the cultural risks – the approaches used to audit 'big data' mean that a much higher percentage of transactions are reviewed and analysed rigorously by the audit process. This should make it more difficult for false accounting entries to be processed without detection. The audit committee should discuss these risks with the external auditors as part of the audit planning process to help ensure that the external auditors are aware of the 'cultural hot spots', and plan accordingly. The audit plan can encompass not only analytical audit testing but also site visits in person by the audit partner or experienced members of the audit team, so that a meaningful assessment of the culture can be made. The audit committee should discuss their conclusions with the external auditors as well as ensure that any remedial action required is undertaken and given appropriate priority by management.

*Ensure that any serious concerns are escalated*

The board, having delegated these responsibilities to its audit committee, should have procedures in place to ensure that any serious concerns are escalated to it in a prompt and proper fashion. It should have a meaningful, open discussion about the findings of both internal and external audits at least annually and at a stage in the financial reporting cycle that enables any remedial action to be undertaken in a timely and effective manner.

It is sensible for both the head of internal audit and the external audit engagement partner to have formal reporting lines to both the chair of the board and the chair of the audit committee. In addition, it is appropriate for these chairs to have 1:1 review sessions with them at least annually, during which views can be exchanged both ways on the effectiveness of a company's values-based culture – and any perceived threats to responsible financial reporting.

[23] Chartered Institute of Internal Auditors (2014) Culture and the Role of Internal Audit: Looking Below the Surface, Foreword

Executive pay linked to the achievement of financial performance targets is clearly a potential threat to the integrity of the financial reporting process and the judgements made, especially when the performance targets are very stretching and the marginal rewards to the executives for achieving them are significant. The consequences of this potential threat are compounded and can be toxic when combined with an unhealthy culture. It is best practice for the performance targets proposed by the remuneration committee to be discussed and agreed with the audit committee prior to them being approved to make sure they are not only relevant and appropriate but also neither too easy nor too difficult to achieve.

> *Executive pay is clearly a potential threat to the integrity of the financial reporting process*

> *'Pressure to meet unrealistic objectives or deadlines was by a wide margin the strongest factor likely to compromise an organisation's ethical standards'* [24]

Similarly, independent non-executive directors need to be constantly alert to leveraged reporting risks related to executive pay. Seemingly small changes to the reported financial performance can sometimes have a disproportionate impact – upwards or downwards – on the incentive payments triggered for executives. It is important that the audit committee and remuneration committee interaction considers the implications of reported financial performance for financial rewards accruing to the executive team.

Pride comes before a fall and reputational conflicts – corporate and personal – can simmer underneath the surface and have implications for the integrity of financial reporting. Companies that are acclaimed by the market for having an unbroken run of increased profits are particularly vulnerable. The market reaction to the trend being broken can be savage on the share price and shareholders can be unforgiving when it comes to the company's leadership. Conversely, companies that have a torrid reputation for delivering consistent losses are vulnerable to putting a favourable gloss on lacklustre financial performance with a view to breaking free from the shackles of shame. These reputational risks to responsible financial reporting can present serious challenges to independent non-executive directors who can be torn between their responsibility to do the right thing in presenting a true and far view, and their feelings of loyalty to the unitary board on which they serve and the senior management that supports them. Also, because by association their own reputations are intrinsically entwined with that of the company, they are exposed to the risks of bias with a view to keeping their own reputational escutcheon untarnished.

One of the most challenging and pernicious threats to responsible financial reporting arises when the chair of the board is compromised and fails to provide the right tone from the top. It is relevant to note that under the UK Corporate Governance Code, chairmen only have to meet specified independence criteria at the time of appointment. [25]

[24] American Management Association (2006), *The Ethical Enterprise – a Global Study of Business Ethics* (a survey of 1,121 global mangers and HR experts)

[25] Financial Reporting Council (2016) *The UK Corporate Governance Code*, Code Provision A.3.1

Although in the majority of cases, chairmen do provide strong and independent leadership throughout their appointment, this is not always the case. When it comes to responsible financial reporting, one of the more significant symptoms of compromised independence is when the chairman's views become too closely aligned with those of the executive directors. This can reinforce inappropriately a tendency towards being behaviourally over-optimistic. In such situations, independent non-executive directors can be in an invidious position since, by definition, the boardroom culture has been corrupted and they may not feel comfortable about raising concerns.

> *This can reinforce inappropriately a tendency towards being behaviourally over-optimistic*

> *'It can be difficult for non-executive directors (NEDs) to obtain sufficient knowledge of business operations to challenge management effectively. It is important for the chairman to set the tone in the boardroom so that NEDs are empowered to raise concerns where they have doubts.'*
>
> FRC (2016) Corporate Culture and the Role of Boards

The public consequences of reporting poor performance are never far from a board's mind when considering the approval of financial results that are likely to lead to an adverse share price reaction and incur the public wrath of shareholders and professional pundits. The executive directors are likely to be on the back foot and the board as a whole should be having regard to any adverse fall-out with customers and other stakeholders that could undermine the company's success and financial viability. It is at such times that independent non-executives have to be true to their ethical principles. They must take a firm but constructive line to ensure that, whatever mitigating actions are proposed, the resulting financial reports show a true and fair view and, importantly, that their presentation is balanced and reasonable. It is emphasised that it is not sufficient merely to defer to the view of the auditors. It is the directors who have the primary responsibility for the financial statements and shareholders expect them to raise concerns rigorously and challenge management and the auditors where they have serious doubts about the financial statements and their presentation. Such situations also underscore the important benefits that accrue from the board reviewing and approving the 'Q and As' and media releases that typically accompany the release of financial information into the public domain. It is important that these communications uphold the principles of responsible financial reporting, just as much as the financial statements themselves. Spin should be shunned and all public comments should stand up to scrutiny. It should be remembered that these communications are not audited, which should sharpen the sense of responsibility that lies with the board.

> *Spin should be shunned*

In recent years, the threats posed by taxation have moved to the top of the totem pole. In the past, a virtue was made of paying as little tax as possible – or even none at all. Now that is seen as a vice. The shift in public and political perceptions is a clear demonstration of how the era of shareholder supremacy is coming to an end and how the interests of society are in the ascent. This has significant implications for responsible financial reporting. Already, a strict disclosure regime has been introduced, with companies having to disclose where they pay tax and how much is paid. In October 2016, the FRC published a thematic review of tax disclosures, [26] which includes a number of illustrative disclosures that meet best practice. The Review also provides commentary on a number of disclosure practices that should be improved. Boards should familiarise themselves with the findings of the FRC's review and apply them when preparing their financial statements. The threats come from a number of directions. For example, a scrutiny of tax practices often exposes a number of uncomfortable truths that, in the clear light of day, are not compatible with the company's values and culture. Historically, such practices were often condoned explicitly by the board and/or its committees. This presents a conflict for the board when it comes to providing increased transparency about the arrangements and how they are to be unwound. Furthermore, from a corporate point of view, reputational risks arise when companies are pilloried in the media for not paying 'their fair share' of tax. Independent non-executive directors have a critical role to play in ensuring that not only the monetary amounts have been correctly calculated, but also that the narrative disclosures present the company's tax affairs and position truthfully.

> *A scrutiny of tax practices often exposes a number of uncomfortable truths*

**Extracts from the FRC Corporate Reporting Thematic Review: Tax Disclosures – Opportunities to Improve Disclosure**

Opportunities were identified for companies to improve the usefulness of their disclosure of significant judgements and estimation uncertainties relating to tax. We encourage companies to:

- Consider carefully whether there are significant judgements and estimation uncertainties relating to tax. Where estimation uncertainties are repeated unchanged year on year, we will question whether the disclosure of quantified risk specifically relating to the next year is clear.
- Appraise what specific information about judgements and estimation uncertainties would be most helpful to users of the accounts. In its project 'Accounting Policies and Integration of Related Financial Information', the FRC's Financial Reporting Lab found that investors value an understanding of the judgements made and estimations applied by management, including where that judgement sits within a range of possible or acceptable outcomes.

[26] Financial Reporting Council (2016) *Corporate Reporting Thematic Review: Tax Disclosures*

The threat of a takeover poses a different set of threats to responsible financial reporting, especially when the short-term financial performance is likely to expose the company's vulnerability to an offer that undervalues its long-term potential. The board can find itself between a rock and a hard place when assumptions and judgements have to be made that could determine the fate of the company and its employees. The auditors, of course, provide a vital check and balance to protect the interests of the shareholders but in the first instance, it is the directors who have to prepare financial statements that purport to show a true and fair view. There is a real risk in these situations that the directors fail to apply judgements that accord with the hallmarks of responsible financial reporting, preferring to paint a picture that flatters financial reality. Independent non-executive directors must be alert to the risks of misreporting the truth and they must be prepared to take a firm line if they believe the integrity of responsible financial reporting is at risk of being prejudiced.

Similarly, this applies when the dividend comes under threat relative to market and shareholder expectations. Dividend cover, distributable reserves and cash flow all come into sharp focus. For many companies, an adverse change in dividend policy, especially when the possibility has not been well heralded, is seen as a breach of covenant with the market; it can cause the share price to dive and confidence in the company, its board and its management, to collapse. Clearly the board has to make balanced judgements in these situations but they must do so by placing reliance on forecast information prepared by management, especially as it relates to cash flow and dividend cover in future years. In such circumstances, it may be wise for the board to instruct the auditors to undertake an independent review of the forecast information in order to provide them with comfort on both the reasonableness of the assumptions used for the forecasts as well as on their compilation and presentation.

Asymmetry of information is a fact of corporate life and underscores the importance of having an open culture that embraces integrity. The boardroom is no exception. It is inevitable that management has better information than non-executive directors. Even between independent non-executives, some will have better information than others – for example, those on the audit committee will have a better knowledge about accounting and auditing at the company than those who are not.

“

*Asymmetry of information is a fact of corporate life*

*In contract theory and economics, **information asymmetry** deals with the study of decisions in transactions where one party has more or better **information** than the other. This creates an imbalance of power in transactions, which can sometimes cause the transactions to go awry, a kind of market failure in the worst case.*

Wikipedia (March 2017)

In the context of ethical threats when preparing and approving financial statements, this means that management may be tempted to use their knowledge advantage in order to hide fraudulent activities by not disclosing material information to the board and its audit committee. Similarly, the audit committee might be economical with the truth when reporting to the board in a way that is designed to avoid awkward questions being asked. These may come from independent non-executives who are not members of the audit committee about those aspects of the audit or the financial statements that might reflect badly within the boardroom on the rigour of the audit committee and require it to do more work. Independent non-executives – both those who serve on the audit committee and those who do not – have a responsibility to be alert to the asymmetries of information and its consequences. However, as a practical matter, effective boards and audit committees have to operate on a basis of mutual trust and constructive challenge. Therefore, it is not appropriate for independent non-executives to challenge constantly but if they do have concerns arising from the asymmetry of information that could give rise to material misstatements or are otherwise significant, then they do have a responsibility to follow through on those concerns until they are satisfied with the outcome.

“ *Independent non-executives do have a responsibility to follow through on concerns until they are satisfied*

# The Critical Dilemmas

The context and the hallmarks of, along with the ethical threats to responsible financial reporting, provide boards with a matrix of considerations that have to be factored into its culture and its decision-making. To assist independent non-executive directors – particularly those who do not have financial experience – this section examines some of the specific accounting and reporting issues and dilemmas, where the matrix of considerations engages with decision-making by the board and its audit committee.

## Revenue recognition – is it really revenue in the current year?

Getting the top line right is critical to determining profitability and dividend cover and capacity. Also, analysts and investors will often focus on the trends in sales growth when assessing the future financial prospects of the company and this can be a key determinant of the direction of the company's share price in both the short and long-term. There can be unwelcome incentives to manipulate the recognition of sales revenue in order to be seen to maintain top line growth, dividend growth and dividend cover. At a basic level, this can be done by 'bringing forward' sales from the next financial year into the current one by booking invoices for shipments that are not made to the customer until after the year-end. At a more complex level, when accounting for construction contracts or the provision of services, there is often difficulty in determining the cut-off point for booking revenue to the current year or to future years. In a number of industries, contractual relationships are becoming more complex. This is reflected in the description of revenue recognition risk in the external auditor's report by Deloitte in respect of GKN's 2016 financial statements – see Box below.

**Extract from the *Independent Auditor's Report to the Members of GKN plc* by Deloitte in respect of the 2016 financial statements**

Revenue recognition – risk description

*'We have also identified a key risk in the accuracy and occurrence of other material contract variations on existing contracts that have arisen in the year and material new contracts in the year.*

*We note that contracts with customers sometimes contain multiple performance obligations and require the Directors to exercise judgement over the appropriateness of the accounting treatment for each individual part of the contract or arrangement.'*

Where transactions associated with these contracts, individually or collectively, are material to a 'true and fair view', the directors have a responsibility to satisfy themselves that they have a good understanding of both the substance and the form of the contracts in order that they can exercise informed judgement about revenue recognition. Inappropriate revenue recognition can have cumulative consequences and if independent non-executive directors have concerns, they must not be fobbed off with explanations such as 'this is how we did it last year'. The views and perspectives on recently appointed independent non-executive directors can be very insightful in this regard.

## Should we be providing more realistically for our contingent liabilities?

Contingent liabilities, such as possible regulatory fines or liabilities that may arise under onerous contracts can bring a raft of challenging ethical dilemmas. This is especially the case in an environment, as currently, where regulators and courts are becoming more assertive in enforcement and levying increased fines for similar offences. The first dilemma is often whether to make financial provision for a contingent liability. Such provision could, on the one hand, be seen as an admission of guilt or liability and thereby prejudicial to the ultimate outcome of the inherent uncertainty. On the other hand, such provision could be seen as prudent and consistent with the provision of a true and fair view. The second dilemma often arises from determining what is the 'right' amount to provide. In the banking sector, in the years since the financial crisis, there has been a tendency to provide a long list of all the contingent liabilities and be slow to recognise any financial liability in the financial statements. And when amounts have been provided, they have often been too low, with the consequence that there has been a continual stream of 'top-up' provisions, which has irritated investors and others.

> *Contingent liabilities can bring a raft of challenging ethical dilemmas*

The directors can face a difficult ethical conflict when it comes to liability and contingent liability recognition and disclosure because they can be liable to suffer personally. A personal reputation that is left in tatters is a high price to pay, over and above any financial loss. Often the views of lawyers are sought and the advice they provide should be taken into account by the board – it is still the board's responsibility – and its audit committee. But a word of caution: it should always be born in mind that their advice may be potentially conflicted if they have already been retained to provide advice in respect of the resolution of the situation giving rise to the contingent liability. Likewise, the role of the external auditors is to audit the information prepared by the board, not to advise on the recognition and measurement of assets or liabilities.

## Mark-to-market valuations – do we really understand how they have been calculated and the suitability of the assumptions used?

Arguably mark-to-market valuations can at times be more reliant on judgements and assumptions than any other component of the financial statements. This can arise in a number of different scenarios, ranging from determining pension fund valuations to calculating the value of options and complex financial instruments. The judgements, assumptions and calculations can be mind-blowing and inherently complex but they can be critical to whether the financial statements show a true and fair view. To complicate matters, the more complex calculations are made using proprietary 'black box' methodology that is not transparent and reliance is placed on valuation experts, which makes it difficult for directors to challenge the resulting valuations effectively. The failure of directors at banks and other financial institutions to challenge valuations effectively was one of the main contributors to the financial crisis. The external auditors face similar challenges and the audit team has to rely on their own in-house experts to provide the audit team with appropriate assurance.

However, there is one part of the 'black box' process on which the board can take a view – namely, the reasonableness of the assumptions that are used. In doing so, they should be wary of assumptions that are unduly optimistic and seek to satisfy themselves that an appropriate degree of responsible prudence has been brought to bear. These assumptions can relate to the terms of the underlying contracts that are being valued, the liquidity and relevance of the markets being used for valuation purposes, and so on. Anecdotally, one hears of significant variations between companies in the mark-to-market valuations of identical assets and liabilities, which serves to underscore their vulnerability to material error.

*Be wary of assumptions that are unduly optimistic*

*'However, regulators from multiple jurisdictions have raised concerns about the confusion resulting from a large number of valuation professional organisations developing their own standards.'*

Steven J. Sherman, former Chair of the International Valuation Standards Board and Managing Director of Loop Capital [27]

As well as scrutinising, carefully, the assumptions that are used, the board and audit committee should be satisfied that the internal auditors regularly review and report favourably on the valuation process and that they demonstrate a good understanding of it. If the valuations are material, in isolation or in aggregate, and the independent non-executive directors have concerns about the valuations or the process that is being used, then they should insist on an independent review and consider its findings carefully before signing off the accounts. The International Valuation Standards Council, which is chaired by Sir David Tweedie, published in 2017 a suite of Professional Valuation Standards to underpin consistency, transparency and confidence in valuations that are key to investment decisions as well as financial reporting. [28]

## Are the receivables really receivable?

The answer to this question should be straightforward but it can be difficult for independent non-executive directors to make a meaningful assessment, especially if, for example, the amount due is conditional on contract performance or management is incentivised to present an overly optimistic view – and in very exceptional situations may fraudulently do so. The chain of information asymmetry can be particularly unhelpful, especially when the amounts receivable arise at overseas subsidiaries such that even senior management at the holding company are vulnerable to 'having the wool pulled over their eyes' by local management, who for self-serving reasons want to mask the reality of recoverability. In the normal course, boards and audit committees should regularly review an aged list of receivables and question with scepticism those that are overdue when the amounts involved are material.

[27] Steven J. Sherman's article discusses the importance of harmonised valuation standards for the global economy: https://www.ivsc.org/news/article/ivsc-s-work-to-improve-standards-for-the-valuation-profession-enhancing-understanding-across-the-global-economy

[28] https://www.ivsc.org/news/article/ivsc-launches-new-global-standards-for-valuation-profession

They should also ensure that internal audit carry out regular reviews on such unduly overdue balances and report their findings to the audit committee or board, as appropriate.

## Are the goodwill assumptions realistic and reasonable?

> *The valuation of intangible assets is both an art and a science*

The valuation of intangible assets is both an art and a science. It requires vision to understand the internal and external factors that will impact – positively and negatively – on the overall viability of the asset giving rise to the goodwill. It also requires a critical assessment of the discounted future cash flows that are attributable to the asset, over both the short and the long-term. This requires the independent non-executive directors to bring to bear the full ambit of their experience – both within and without the company – in making decisions that are objective, rather than being prejudiced inappropriately by favourable management bias.

## To capitalise or not to capitalise?

One of the easiest ways to massage profitability is to defer the recognition of costs to future periods. Companies will generally have clear guidelines about how to account for transactions as revenue or capital but it is surprising how frequently restatements have to be made. One of the biggest ethical quandaries can arise in respect of the cost of major systems improvements, projects that can sometimes straddle several years and the delivery of the anticipated benefits is uncertain, for whatever reason. To book the development costs in the period incurred can be a big hit to reported profitability, which the board and management are usually keen to avoid. Therefore, it is important that, if the amounts involved are material, the board and its audit committee bring an appropriate degree of scepticism and challenge to bear to satisfy themselves that the evaluation of the relevant facts has yielded the right outcome from the point of view of responsible financial reporting. They should also consider carefully the integrity of the facts themselves to ensure, for example, that bad news as to progress is not being supressed.

> *It is important that the board and its audit committee bring an appropriate degree of scepticism*

## Should we change the pension fund assumptions?

Pension fund liabilities have been a thorn in the flesh for many companies. The risks associated with unmitigated pension fund risks can be significant and they can create a serious conflict between the directors' legal duties to shareholders and employees. In the wake of the BHS scandal, the Pensions Regulator is raising its regulatory game.

### The BHS scandal and the pension fund assumptions – extracts from the BHS Report of the Work and Pensions, and Business, Innovation and Skills Select Committees [29]

*'When Sir Philip Green bought BHS, the pension schemes for which he became responsible were in surplus. As these schemes declined into substantial and unsustainable deficit he and his directors repeatedly resisted requests from trustees for higher contributions. Such contributions were not charitable donations: they were the means of the employer meeting its obligations for deferred pay. We reject any assertion that Sir Philip was not aware of the growth of the deficit: he had a responsibility to be aware and he was aware. That there is a massive deficit is ultimately Sir Philip Green's responsibility.*

*The 23 year recovery period for the pension scheme established in 2013 was extraordinary. The annual payments of £10 million, which were calculated with no apparent regard to the sustainability of the scheme, were presented to the trustees as a non-negotiable offer. The payments were wholly inadequate and the deficit continued to grow.'*

In future, it is very possible that the Pensions Regulator will exercise its rights more frequently to prevent companies paying dividends or undertaking a strategic restructuring when it feels that there is a risk that the interests of the pension fund and its members may be adversely affected. Also, investors and lenders may pay particular attention to the reported pension liabilities in assessing investment and covenant risks. Small changes in respect of some of the assumptions used – for example in respect of the discount rate or the longevity of members – can have a material impact on the size of the reported pension fund liability. The board has a responsibility to make a proper assessment of the assumptions used, and the independent non-executives have an important role to play in this if the executive directors and senior management are conflicted by virtue of being members of the pension scheme or otherwise having an interest in it – perhaps as a trustee. The issues associated with pension accounting and the assumptions used can be very complex. Therefore, it can be useful to have a 'pensions expert' on the board but it is important that the other directors do not abdicate their responsibility to the expert. In the final analysis, all the directors are responsible for the assumptions used, not just the 'expert'.

*All the directors are responsible for the assumptions used, not just the 'expert'*

[29] https://www.publications.parliament.uk/pa/cm201617/cmselect/cmworpen/54/5402.htm

## Will a change in accounting policies spark a significant fall in the share price?

Change has consequences and a significant change to accounting policies that has a material impact on the financial statements could have a significant impact on the share price, especially if it changes market expectations of earnings or dividend policy. Too often the focus of directors is on how accounting policies are applied rather than whether the accounting policies are the right ones to apply to deliver a true and fair view. Directors have a responsibility to consider on an ongoing basis whether the accounting policies are appropriate and take into account the changing environment in which the company operates – and make changes as and when required, even if they are likely to lead to an adverse share price reaction. It might be reasonable to presume that executives will be reluctant to recommend changes to accounting policies that will have an adverse share price impact because it will often reduce their own net worth, and reduce the level of vesting of their conditional share awards. However, it is also important to bear in mind that they may benefit from future performance share awards being priced at lower levels than otherwise. Either way, executive directors are conflicted and it is therefore vital that independent non-executive directors in general, and the audit committee in particular, review the accounting policies at least once a year and challenge constructively and effectively both retaining the status quo and/or making changes. The auditors' views on the accounting policies and relevant matters can help to inform the review and the views of the independent non-executives. In addition, the independent non-executives should consider the benefits of getting independent feedback from other sources in order to lend conviction to the conclusions they reach.

## Will disclosure of information necessary for a true and fair view damage our commercial interests?

Conflicts can arise when the presentation of a true and fair view may require disclosure of information that is prejudicial to the best interests of the company. Directors have a legal requirement, on the one hand, to prepare accounts that prepare a true and fair view and, on the other hand, in accordance with the provisions of Section 172 of the 2006 Companies Act they have a duty *'to promote the success of the company for the benefit of its members as a whole'*. For example, assume that shortly before the year end the board decides to close a major overseas subsidiary, giving rise to onerous contractual obligations. However, it is not planning to make a public announcement for several months to mitigate the risks of customer and staff defections. Under IFRS, full provision of the estimated costs and liabilities is required but to do so will provide valuable intelligence to competitors who may, as a direct consequence, be inclined to adopt disrupting strategies and tactics, luring away customers and staff. Notwithstanding, there may be a temptation not to make the required disclosures or to underestimate the costs and liabilities. This would not be compatible with responsible financial reporting. Rather, full disclosure is required and the board has to manage the consequences, acting in the best interests of the company. In this regard, the independent non-executive directors must scrutinise carefully the disclosures – financial and narrative – to satisfy themselves that they are transparent and not economical with the truth.

> “ *There may be a temptation not to make the required disclosures*

In particular, the audit committee should challenge the adequacy of estimated costs and liabilities, probing and bringing to bear their experience and independent judgement to ensure an appropriate degree of prudence has been applied. The scrutiny and challenge must extend to contingent liabilities which can often be key issues for investors and other users of the financial statements. Independent non-executive directors should not be fobbed-off or constrained by arguments that the contingent liability is not numerically material. Instead, they should stand back and reflect on the substance of the contingent liability and its possible significance to investors and others. Materiality is not black and white; ethical judgement counts.

## To adjust or not to adjust earnings?

Although the primary focus of this Briefing is on financial statements, it would not be complete without commenting on the growing concerns by many investors about the use of and emphasis given to 'adjusted earnings' when a company's financial results are announced. Adjusted earnings reflect changes made by management that are intended to highlight the underlying earnings by stripping out unusual costs and income from the audited financial statements. The essence of these concerns is captured with feeling by Warren Buffet in his 2017 annual letter to the shareholders of Berkshire Hathaway Inc., as set out in the Box below.

> *'Too many managements – and the number seems to grow every year – are looking for any means to report, and indeed feature, "adjusted earnings" that are higher than their company's GAAP earnings. There are many ways for practitioners to perform this legerdemain. Two of their favorites are the omission of "restructuring costs" and "stock-based compensation" as expenses.*
>
> *Charlie and I want managements, in their commentary, to describe unusual items – good or bad – that affect the GAAP numbers. After all, the reason we look at these numbers of the past is to make estimates of the future. But a management that regularly attempts to wave away very real costs by highlighting "adjusted per-share earnings" makes us nervous. That's because bad behavior is contagious: CEOs who overtly look for ways to report high numbers tend to foster a culture in which subordinates strive to be "helpful" as well. Goals like that can lead, for example, to insurers underestimating their loss reserves, a practice that has destroyed many industry participants.*
>
> *Charlie and I cringe when we hear analysts talk admiringly about managements who always "make the numbers." In truth, business is too unpredictable for the numbers always to be met. Inevitably, surprises occur. When they do, a CEO whose focus is centered on Wall Street will be tempted to make up the numbers.'*
>
> Warren E. Buffett, Chairman of the Board, Berkshire Hathaway Inc. (2017) [30]

[30] http://www.berkshirehathaway.com/letters/2016ltr.pdf

One of the biggest challenges to the integrity of today's corporate reporting is in the adjustments made to the audited financial statements that have been approved by a board of directors as showing a true and fair view. It is vital that the board devote sufficient time to scrutinising the nature of and justification for any such adjustments in order to satisfy themselves they are both appropriate and made with integrity. This scrutiny should encompass not only the information provided in the preliminary announcement of the annual results but also in any related press releases, as well as in the presentational material used on the investor roadshows. As Warren Buffett implies, investors expect the board to show backbone in fulfilling this responsibility.

> *Investors expect the board to show backbone*

# The Implications for Independent Non-Executive Directors

Independent non-executive directors, whether or not they are members of the audit committee, play a critical role in ensuring that companies report responsibly. They provide an essential check and balance, not just in relation to the financial reporting process itself but also in considering the implications for financial reporting when fulfilling their other non-executive responsibilities. This involves assessing culture, evaluating the consequences of risk and risk appetite, and ensuring executive pay and key performance indicators (KPIs) are aligned with sustainable outcomes rather than short-term gratification.

> "Independent non-executive directors provide an essential check and balance

## Sustainable and achievable KPIs

In many businesses, KPIs are an integral part of good management, providing boards with a dashboard to monitor and influence performance and providing executives with performance incentives that are central to executive compensation. But poorly designed and managed KPIs can deliver perverse outcomes, and when significant short-term rewards are on offer for achieving short-term performance targets, they can motivate management to corrupt the truth when preparing and presenting financial statements. The independent directors who serve on board committees other than the audit committee should always be mindful of KPI implications – behavioural and otherwise – for responsible financial reporting. In turn, the independent non-executive directors who serve on the audit committee must be constantly alert to performance relative to KPIs and maintain their objectivity, ensuring that they uphold the hallmarks of responsible financial reporting and resist the temptation to bias when adopting or applying accounting policies that may deceive to flatter corporate and management performance.

> "Accounting policies may deceive to flatter corporate and management performance

## Challenge accounting policies and how they are applied

One of the most important and enduring lessons from the financial crisis is the importance of constructive and effective challenge by independent non-executive directors. In particular, they must have – and demonstrate that they have – the courage to challenge management and received wisdom. When it comes to responsible financial reporting, they should 'kick the tyres' of the accounting policies and practices that have been applied in the past, to satisfy themselves that they remain appropriate and fit for purpose, consistent with the presentation of a true and fair view. If an independent non-executive director has doubts, he or she has a responsibility to probe and challenge until such time as those doubts are resolved – or the questionable accounting policy or practice is changed.

It would be irresponsible of an independent non-executive director to support the approval of financial statements if the doubts are still festering. The option of a true and fair override should never be overlooked and those boards that decide to invoke it for the right reasons deserve credit for having the courage to do so. The same applies when management recommends a new policy or a change to the way an existing policy is applied. The motives for change need to be considered carefully as well as the financial reporting consequences. The external auditors are likely to opine on any change, especially if it has material consequences, which can be helpful and reassuring but if doubts linger, an independent non-executive director should obtain a second external opinion.

“ *The option of a true and fair override should never be overlooked*

## Challenge the accuracy and completeness of information received from executives

The FRC's Guidance on Board Effectiveness states that *'Non-executive directors should insist on receiving high-quality information sufficiently in advance, so that there can be thorough consideration of the issues prior to, and informed debate and challenge at, board meetings. High-quality information is that which is appropriate for making decisions on the issue at hand – it should be accurate, clear, comprehensive, up-to-date and timely; contain a summary of the contents of any paper; and inform the director of what is expected of him or her on that issue.'* [31]

“ *Those who have concerns or questions would be culpable if they did not raise them*

In respect of responsible financial reporting, such insistence by the independent non-executive directors is critical to their effective participation at the audit committee and board meetings. There can be a natural tendency in a collegiate, unitary board for independent non-executive directors to be accepting of the information presented by management and to make decisions 'on the nod' without 'informed challenge and debate'. However, that would be a dereliction of duty, especially when it pertains to responsible financial reporting. Conflicts can abound and the presentation of a true and fair view can be compromised by the provision to directors of incomplete information and/or inadequate debate and challenge in the boardroom. The chairman, of course, has an important responsibility to ensure that this happens but independent non-executive directors must have the courage to speak up and challenge the accuracy and completeness of information when he or she considers it to be appropriate and consistent with the presentation of a true and fair view. Those who have concerns or questions would be culpable if they did not raise them with due challenge and, when appropriate, scepticism.

[31] Financial Reporting Council (2011) *Guidance on Board Effectiveness*, Paragraph 1.22

## Probe related party transactions

Transactions with related parties are a fact of life but when viewed through the lens of the shareholder and stakeholder, some can be more controversial than others. At the very least, their disclosure invites unwelcome attention and scrutiny, often disproportionate to the sum involved. Although the amounts involved may not be material in the context of the financial statements taken as a whole, a much lower materiality threshold is generally appropriate when dealing with related party transactions because of their very nature. This is particularly true when such transactions are with parties who are related to the directors or senior management. Consistent with the hallmark of completeness, it is very important that independent non-executives satisfy themselves that all related parties with whom there have been transactions have been identified and that all the transactions have been properly accounted for in the financial statements. Failure to do so can invoke regulatory investigation. This is illustrated by the following announcement by the FRC into the failure of Sports Direct to disclose in the financial statements transactions between the company and a company controlled by the brother of Mike Ashley, Sports Direct's majority shareholder and Deputy Chairman.

> "Failure to account for all transactions in financial statements can invoke regulatory investigation"

The Financial Reporting Council (FRC) has commenced investigations under the Accountancy Scheme and the Audit Enforcement Procedure in relation to the preparation, approval and audit of the financial statements of Sports Direct International plc ("Sports Direct") for the 52 week period ended 24 April 2016. These decisions follow reports of an arrangement between Sports Direct and Barlin Delivery Limited which was not disclosed as a related party in the company's financial statements.

Financial Reporting Council Press Notice (2016) [32]

## Listen carefully to those who raise concerns (speak up/whistleblowers)

To speak up with integrity takes moral courage of the highest order and whistleblowers deserve commensurate respect. The accounting scandals at Olympus, the Japanese manufacturer of optical products, could have been avoided – or at least their consequences minimised – if the concerns about improper management and accounting practices that were expressed by Michael Woodford had been listened to and acted on properly when they were first raised.

> "To speak up takes moral courage of the highest order"

[32] https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2016/November/Investigations-into-the-preparation,-approval-and.aspx

Joining Olympus in 1981 and rising to manage its European operations, Woodford was the first non-Japanese person to be appointed as the company's CEO in October 2011,[2] having "exceeded expectations" as president and chief operating officer for the previous six months.[3] Within two months, he became a central figure in exposing the Olympus scandal, having been removed from his position when he persisted in questioning fees in excess of $1 billion that Olympus had paid to obscure companies (which appear to have been used to hide old losses and appeared to have organised crime connections). The scandal rocked Japanese corporate governance, led to the resignation of the entire Olympus board and several arrests of senior executives, including the previous CEO and chairman, and the company's former auditor and bankers among others, and made Woodford one of the most highly placed executives to turn whistleblower.[4] By 2012, the scandal he exposed had developed into one of the biggest and longest-lived loss-concealing financial scandals in the history of corporate Japan.[5][6] [33]

Independent non-executive directors must take responsibility for ensuring that the company has a speak up or whistleblowing system that operates throughout the company – not just at head office – with the highest standards of integrity and, in particular, that it cannot be overridden or subverted by management. But that is not all; they must engage with whistleblowers when significant – or potentially significant – issues arise and consider carefully the information that is shared by them, taking independent steps to verify it or otherwise, rather than turning a blind eye.

## Listen to shareholders and analysts

It is arguably a truism that 'the best advice is free advice'. There are over 300 asset owners and asset managers signed up to the UK Stewardship Code, which is published and overseen by the Financial Reporting Council. It provides a principles-based comply-or-explain framework to assist institutional investors fulfilling their stewardship responsibilities on behalf of their clients or beneficiaries. The Code provides that, as a matter of principle, *'Institutional investors should monitor their investee companies'* and in support of this, it offers guidance including *'When monitoring companies, institutional investors should seek to…. consider the quality of the company's reporting'*. [34] Furthermore, the UK Corporate Governance Code provides that 'There should be a dialogue with shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place.' It follows that the board – including the independent non-executive directors and not just the chairman, the CEO and the CFO – has a responsibility to seek feedback from shareholders about the quality of the company's financial statements and the shareholders have an implied responsibility to provide such feedback. Bearing in mind that shareholders are the primary users of the financial statements, they should not shirk from this responsibility; their views should be invaluable and should be listened to and evaluated carefully by the independent non-executive directors.

[33] Wikipedia entry for Michael Woodford (N.B. Wikipedia has embedded footnotes as noted above)

[34] Financial Reporting Council (2012), *The UK Stewardship Code*, Principle 3

If management or the board decides not to proceed in line with the feedback provided by the shareholders – particularly from those who have a long-term relationship with the company – then the independent directors should satisfy themselves that the rationale for not doing so is sound and consistent with the hallmarks of responsible financial reporting.

Similarly, professional analysts who follow the company will often comment directly or indirectly about the quality of financial reporting in their research reports to their clients. Bearing in mind that these analysts often analyse in some detail financial information from different companies in the same sector, they bring the benefits of specialisation to bear when reaching their views. Accordingly, independent non-executive directors should go out of their way to obtain and understand the views of analysts – especially those who are not recommending that their clients buy the company's stock – and consider carefully whether they have implications for improving the quality of the future financial statements. Because such analysts are sometimes critical of the company's management, there may be a tendency among executive directors to suppress the communication to the board of adverse commentaries. Independent non-executive directors should be mindful of this potential conflict of interest when seeking feedback provided by professional analysts. There is no substitute to hearing it from the horse's mouth.

*"There is no substitute to hearing it from the horse's mouth*

## Meet in private session without the executive directors

Boards that adopt best practice corporate governance generally make regular provision for the independent non-executives to meet without the executive directors in order that they can discuss issues openly and in an appropriate environment. Without such meetings (they are sometimes called 'executive sessions'), independent non-executives may find it difficult to express views and opinions that relate to a range of relevant issues, including cultural leadership and environment within the finance function. If such meetings take place on a systematic and regular basis, they are not generally perceived with hostility by the executives, whereas it can sometimes be challenging to convene such meetings on an *ad hoc* basis without causing tensions that might be unnecessary and unhelpful. They provide a forum for independent directors to share concerns and views, which can often help to resolve issues – or add conviction to them. As well as culture and cultural leadership, it is beneficial for financial reporting issues to feature, when appropriate, on the meeting agendas.

*"Sometimes it appears that there is insufficient discussion of the financial statements at the board*

## The buck stops with the board

It is the board – not the audit committee – that is responsible for preparing and approving financial statements that show a true and fair view. It is important to remember that the audit committee is merely a sub-committee of the board and has no direct or formal responsibility to shareholders or other stakeholders.

Sometimes it appears that there is insufficient discussion of the financial statements at the board, especially when they are being presented for approval by the board. Independent non-executives who do not have a financial background may be tempted to 'switch off', just at a time when they should in fact be 'switched on' and asking probing and challenging questions until they are satisfied that the financial statements do indeed show a true and fair view. It is their duty to do so.

## Ensure the external auditors apply professional scepticism

Auditors are paid to be sceptical but the history of financial failures is littered with tales of auditors who have been too inclined to give management the benefit of the doubt when it would have been far more professional to stand their ground. It is, of course, primarily the responsibility of the auditors to bring professional scepticism to bear but the audit committee and independent non-executive director also have a role to play. In particular, when the audit plan is being discussed with the auditors, at the start of the reporting cycle, the audit committee should emphasise to the audit team the importance it attaches to the auditor applying professional scepticism effectively. And when the audit is being concluded, the audit committee should probe how scepticism was brought to bear during the audit, asking for some specific examples to help ensure the auditor does not merely apply lip service to this essential ingredient of audit quality. Furthermore, the independent non-executive directors should always insist that the audit engagement partner – and possibly other members of the audit team – attend and speak at the board meeting when the financial statements are to be approved. There should be a meaningful discussion with the auditors to discuss the key audit issues that arose and how they were resolved, and they should challenge the auditors to demonstrate how they brought professional scepticism to bear.

> “ *The Board should challenge the auditors*

## Values – application and accountability

Too often, boards forget that corporate values have to be applied throughout the company – and the boardroom is certainly no exception. At all stages of the corporate reporting process, the board must keep the company's values at the centre of its discussions and decision-making. Every director has a responsibility to uphold them and the chairman of the board has a responsibility to make sure they are infused into all the board's discussions and decisions, including those relating to the financial statements. It is a useful discipline to include a statement of the corporate values in the board papers and refer to them on a regular basis.

> “ *Corporate values have to be applied throughout the company – and the boardroom is certainly no exception*

When approving the financial statements, the board should affirm explicitly and in a meaningful way that the decisions and judgements made by it were aligned with the company's values and that the values are reflected in the disclosures made, both within the body of financial statements and in the notes thereto. To incorporate a statement of the values within the financial statements and to confirm that the board has complied with them in the preparation and approval of the financial statements sends a powerful message to investors and serves to strengthen the accountability of the board.

# Conclusion

Responsible financial reporting requires an engaged board and an effective audit committee comprising non-executive directors who are demonstrably independent of management and have the personal and professional courage to challenge – and to do so effectively. Without independent non-executive directors who are prepared to question the unquestionable and pursue their concerns to get satisfactory resolution, one way or the other, responsible financial reporting will suffer.

The risks of failing to focus on the ethical dimensions of, and threats to, financial reporting should never be underestimated. Independent non-executive directors must focus their attention on not just the numbers that are crunched, but how they are crunched. They must be vigilant in monitoring the cultural environment within and outside the finance function. This will include the wider company, the company's values and their implications for responsible financial reporting. Their antennae must be constantly tuned into the cultural and ethical signals, and they must be prepared to act when they detect any that might, directly or indirectly, undermine the presentation of a true and fair view. A half empty bottle should not be presented as a half full one.

*The hallmarks of responsible financial reporting are not negotiable*

The hallmarks of responsible financial reporting are not negotiable. Truthfulness, integrity, fair presentation and freedom from bias, prudence, consistency, completeness and comprehensibility provide an interdependent conceptual framework for responsible financial reporting. If one or more of them is absent, then the framework is unstable. Independent non-executive directors are responsible for ensuring these hallmarks are ever-present in the financial statements that are approved by the board as showing a true and fair view.

Seeking to do the right thing by challenging and probing questionable accounting processes, policies and outcomes can be a real test of the strength of non-executive directors' independence and calibre. They may feel pressured and threatened by other directors – executive and non-executive – and even by the auditors, internal and external. Even obtaining independent advice on the issues concerned can be interpreted by others as a lack of trust. Ethical courage is therefore a must.

Doing the right thing was never easy and being prepared to take a stand can be the beginning of the end to the tenure of an independent non-executive director; if they are forced to resign on a matter of principle or concern regarding the integrity of financial reporting, it is not good enough to slip away silently. They must find a way to communicate their concerns to regulators, if appropriate, and shareholders – not least because those of the latter who have signed up to the UK Stewardship Code have a responsibility to consider the quality of financial reporting of their investee companies.

Seeking the truth and ensuring fair presentation are zero-tolerance responsibilities for independent non-executive directors. Responsible financial reporting lies at the heart of responsible capitalism and in today's world, it is in the hands of independent non-executive directors to do the right thing when it comes to corporate reporting.

*Seeking the truth and ensuring fair presentation are zero-tolerance responsibilities*

# Related IBE Publications

IBE publications provide thought leadership and practical guidance to those involved in developing and promoting business ethics, including senior business people, corporate governance professionals and ethics and compliance practitioners.

Some recent publications related to this topic which you might be interested in include:


## Fair or Unfair? getting to grips with executive pay

**Peter Montagnon**

Executive remuneration is an important driver of behaviour and therefore of the way values are perceived throughout a company. However, current approaches to the way pay is set are very complicated and tough for boards to manage. There is a widespread view that the present system in the UK does not deliver the right incentives, and may even be fundamentally broken. This Board Briefing looks at the difficult and complex task of the remuneration committee. It explores seven ethical challenges facing these committees, with fairness and simplicity as the two themes running throughout. It aims to help in identifying and addressing the ethical issues, and also offers some pointers for reform.


## Checking Culture: a new role for internal audit

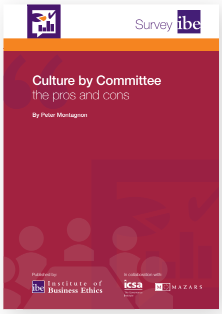
**Peter Montagnon**

Boards are increasingly concerned to embed a sound corporate culture. However the corporate leadership team need to know whether the culture they want is the one they have actually got. Internal audit can help through its work on assurance. This IBE Board Briefing, the second in the series, draws on the experience of those involved at a senior level in a range of organisations. Audit committee chairs, heads of internal audit and heads of ethics and compliance, give practical advice and explain in their own words how to approach the challenge of checking culture.


## Ethics, Risk and Governance

**Peter Montagnon**

Setting the right values and culture is integral to a company's success and its ability to generate value over the longer term. The challenge for business is how to develop and embed real values. This requires leadership and is a core task for boards. Many boards acknowledge the importance of a healthy corporate culture, both because of the role this plays in mitigating risk and because of the value to their franchise of a sound reputation. This IBE Board Briefing sets out why directors need to be actively involved in setting and maintaining a company's ethical values and suggests some ways to approach it. It aims to help directors define their contribution to the maintenance of sound values and culture.



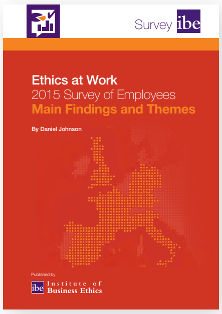

## Culture by Committee: the pros and cons

**Peter Montagnon**

Shifting perceptions of risk have increasingly encouraged companies to form special board committees to deal with broad questions of corporate responsibility, sustainability and ethics. This IBE Survey Report looks at the nature and role of these board committees, and also at the way companies that choose not to have such committees handle this growing range of non-financial risks.

The idea of having a committee dedicated to the task of overseeing culture and ethics is relatively new. This survey report is intended to benchmark what is happening in the UK, providing a valuable insight into how companies are approaching the task, and helping companies decide on the right approach for them in an increasingly complex world.

This survey was prepared in collaboration with ICSA: The Governance Institute and Mazars



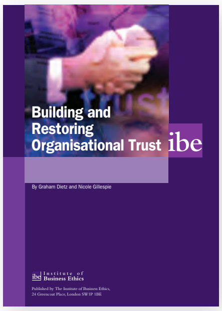

## 2015 Survey of Employees – Main Findings and Themes

**Daniel Johnson**

Employee views are a key indicator of the ethical temperature in today's organisations. What do employees think about the ethical business practices of their employer? What do they consider ethical behaviour? And how much support do they get to 'do the right thing'?

This report presents the main findings from the 2015 IBE Ethics at Work Survey across Britain and the four Continental European countries. It also explores five key themes which emerged from the 2015 Survey relating to the impact of ethics programmes; the experience of younger employees; employees attitudes to certain workplace practices; employee sensitivity to ethical issues; and the difference between managers and non-managers.

Full survey reports are available for Britain, France, Germany, Italy and Spain, with an overview of Continental Europe from our website.

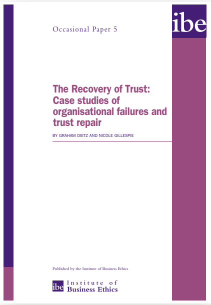



## Building and Restoring Trust

**Grahan Dietz & Nicole Gillespie**

Understanding and managing trust is a critical competency for organisations that take their ethical values seriously. Organisations need to know how trust is won, developed and sustained, and also what to do when that trust is threatened or has broken down.

This Report helps organisations understand what trust is and how it is established at the interpersonal and organisational level. It outlines strategies for building and sustaining a resilient reputation for organisational trustworthiness and, through the use of case studies, illustrates good and poor practice in repairing internal trust after an organisational failure.




## The Recovery of Trust: six case studies of organisational failures and successful trust repair

**Graham Dietz & Nicole Gillespie**

These six case studies describe and analyse the experience and response of companies that have faced a trust failure. These cases demonstrate how the companies – Siemens, Mattel, Toyota, BAE Systems, and Severn Trent – have successfully repaired the loss of trust and provide insight into the process involved.

The Paper supplements the IBE's earlier report, Building and Restoring Organisational Trust.


## Supplier Relationships in the UK: business ethics and procurement practice

**Laura J Spence**

This report examines the complexities of supplier relationships and ethical procurement practice in the UK. It explores how companies can achieve fair relations with their suppliers and particularly considers issues raised in relationships between large organisations and small and medium sized suppliers. Three case studies, from Camelot, Waitrose and Toyota, help draw out the issues and good practice approaches. Guidance on good practice is offered for suppliers and customers alike.


## Living Up To Our Values: developing ethical assurance

**Nicole Dando & Walter Raven**

How can boards be confident that their organisation is living up to its ethical values and commitments? This report provides a practical framework for approaching the assurance of ethical performance against an organisation's own code of ethics. It is addressed to those at board level overseeing assurance that ethical values are embedded, that commitments are being met and management processes are effective. It will assist assurance professionals seeking to broaden their understanding of non-financial issues and is intended as an aid to the development of good practice.

## Other IBE Resources

### Investing in Integrity Charter Mark

Is there a way to prove a company's integrity? The IBE has developed a charter mark in association with the Chartered Institute of Securities and Investment (CISI) to help businesses and organisations know if their ethics programme is embedded throughout their organisation.

The **Investing in Integrity** (IiI) charter mark gives an assurance of trustworthiness to clients, customers, investors and other stakeholders doing business with the organisation. The real strength of the IiI framework is that it tests an organisation's ethical conduct against its statements of values to ensure those values are properly embedded. It can help them identify whether or not the company is truly living up to its values, from the boardroom to the shop floor.

The testing uses a self assessment management questionnaire and third party audit by IiI partner **GoodCorporation** whose methodology has been adapted for the IiI chartermark.

To find out more visit **www.investinginintegrity.org.uk**

### Say No Toolkit

The IBE Say No Toolkit is a decision making tool to help organisations encourage employees to make the right decision in difficult situations. The Say No Toolkit delivers immediate guidance to employees on a wide range of common business issues, especially those that could lead to accusations of bribery.

Employees tap through a series of questions about the situation they face and the tool will provide the right decision to take: Say No, Say Yes or Ask. The answer also makes it clear why it is important to make that decision so your employees can have the confidence and the knowledge to respond correctly.

Organisations can use both the IBE Say No Toolkit app and website for free. The app can be downloaded onto any smartphone or tablet.

You can start using it for free now. Simply go to www.saynotoolkit.net

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## Responsible Financial Reporting
doing the right thing

***IBE Board Briefings aim to support board members and those who advise them by drawing their attention to and suggesting ways to approach particular ethical issues.***

Financial reporting is critical to trust in business. Misleading accounts will undermine the confidence of investors and other stakeholders to the point where financial support can dry up and the franchise is lost. Yet this is more than just a question of conforming to the rules laid down by standard setters. Most accounting involves judgment and all judgment contains an ethical dimension.

In this Board Briefing, Guy Jubb, who is himself a qualified accountant and has spent several decades looking at company accounts from the perspective of an investor, looks at the challenges and the pitfalls. These include the pressures that may come from the short-term pressures of the market or the desire to meet remuneration targets. Or it may simply be a question of wanting to portray one's company in the best possible light.

Where the standards do call for judgement this may lead companies to be economical with the truth. Dilemmas surround issues like revenue recognition, reporting of contingent liabilities and mark-to-market valuations. Guy's wise counsel will help both executives and audit committee members alike in navigating their way through.

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